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No. 06-937

In the Supreme Court of the United States

QUANTA COMPUTER, INC., QUANTA COMPUTER USA, INC., Q-LITY COMPUTER, INC.,

PETITIONERS,

v.

LG ELECTRONICS, INC.,

RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT

REPLY BRIEF FOR PETITIONERS

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TABLE OF CONTENTS

Page

TABLE OF CONTENTS i

TABLE OF AUTHORITIES ii

ARGUMENT 1

I. A PATENTEE CANNOT ALTER THE SCOPE OF ITS PATENT MONOPOLY BY IMPOSING "CONDITIONS" ON USE OR RESALE FOLLOWING AN AUTHORIZED SALE 1

II. AUTHORIZED SALE OF AN UNFINISHED ARTICLE OR COMPONENT CAN TRIGGER EXHAUSTION UNDER THE *UNIVIS* TEST 7

III. SECTION 271(D)(2) DID NOT OVERRULE *UNIVIS* 12

IV. ANY MODIFICATION OF TRADITIONAL EXHAUSTION PRINCIPLES MUST COME FROM CONGRESS 15

V. PUBLIC POLICY FAVORS THE TRADITIONAL EXHAUSTION DOCTRINE 17

VI. METHOD PATENTS CAN BE EXHAUSTED 28

CONCLUSION 29

TABLE OF AUTHORITIES

Page(s)

CASES

Adams v. Burke,
84 U.S. (17 Wall.) 453 (1873) 5

Alexander v. Sandoval,
532 U.S. 275 (2001) 16

Aro Manufacturing Co. v. Convertible Top Replacement Co.,
365 U.S. 336 (1961) 10

Aro Manufacturing Co. v. Convertible Top Replacement Co.,
377 U.S. 476 (1964) 13, 14

Bement v. National Harrow Co.,
186 U.S. 70 (1902) 26

Boesch v. Graff,
133 U.S. 697 (1890) 4

Chaffee v. Boston Belting Co.,
63 U.S. (22 How.) 217 (1859) 15

Dawson Chemical Co. v. Rohm & Haas Co.,
448 U.S. 176 (1980) 13, 14

Deepsouth Packing Co. v. Laitram Corp.,
406 U.S. 518 (1972) 14

TABLE OF AUTHORITIES—Continued

Page(s)

Dennison Manufacturing Co. v. Ben Clements & Sons, Inc.,
467 F. Supp. 391 (S.D.N.Y. 1979) 3

Director, Office of Workers' Comp. Programs v. Newport News Shipbuilding & Dry Dock Co.,
514 U.S. 122 (1995) 14

Ethicon, Inc. v. United States Surgical Corp.,
135 F.3d 1456 (Fed. Cir.), *cert. denied*, 525 U.S. 923 (1998) 15

Ethyl Gasoline Corp. v. United States,
309 U.S. 436 (1940) 28

General Talking Pictures Corp. v. Western Electric Co.,
305 U.S. 124 (1938) 5

Glenayre Electronics, Inc. v. Jackson,
443 F.3d 851 (Fed. Cir.), *cert. denied*, 127 S. Ct. 582 (2006) 27

Hobbie v. Jennison,
149 U.S. 355 (1893) 5

Illinois Tool Works, Inc. v. Independent Ink, Inc.,
547 U.S. 28 (2006) 1

TABLE OF AUTHORITIES—Continued

Page(s)

In re Aimster Copyright Litigation,
334 F.3d 643 (7th Cir. 2003), *cert. denied*,
540 U.S. 1107 (2004) 3

In re Zurko,
142 F.3d 1447 (Fed. Cir. 1998), *rev'd on other grounds*, 527 U.S. 150 (1999) 16

Keeler v. Standard Folding Bed Co.,
157 U.S. 659 (1895) 5, 15, 20

Lear, Inc. v. Adkins,
395 U.S. 653 (1969) 21

Leegin Creative Leather Products, Inc. v. PSKS, Inc.,
127 S. Ct. 2705 (2007) 1

Lucas Aerospace, Ltd. v. Unison Industries, L.P.,
899 F. Supp. 1268 (D. Del. 1995) 3

Lucent Technologies Inc. v. Gateway, Inc.,
509 F. Supp. 2d 912 (S.D. Cal. 2007) 27

Mallinckrodt, Inc. v. Medipart, Inc.,
976 F.2d 700 (Fed. Cir. 1992) 26

MedImmune, Inc. v. Genentech, Inc.,
127 S. Ct. 764 (2007) 23

TABLE OF AUTHORITIES—Continued

Page(s)

Mercoid Corp. v. Mid-Continent Investment Co.,
320 U.S. 661 (1944) 10, 13

Mitchell v. Hawley,
83 U.S. (16 Wall.) 544 (1873) 18

Motion Picture Patents Co. v. Universal Film Manufacturing Co.,
243 U.S. 502 (1917) 20

Pierce v. Allen B. Dumont Laboratories, Inc.,
297 F.2d 323 (3d Cir. 1961) 9

Public Citizen v. United States Department of Justice,
491 U.S. 440 (1989) 14

State Oil Co. v. Khan,
522 U.S. 3 (1997) 16

United States v. General Electric Co.,
272 U.S. 476 (1926) 26

United States v. Masonite Corp.,
316 U.S. 265 (1942) 15

United States v. Univis Lens Co.,
316 U.S. 241 (1942) 1, 7, 8, 11, 26

United States v. X-Citement Video, Inc.,
513 U.S. 64 (1994) 14

TABLE OF AUTHORITIES—Continued

Page(s)

STATUTES

17 U.S.C. §109(b) 16

35 U.S.C. §261 15

35 U.S.C. §271(d) 13

35 U.S.C. §271(d)(2) 12

OTHER AUTHORITY

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Richard H. Stern, *The Unobserved Demise of the Exhaustion Doctrine in US Patent Law*, 15 Eur. Intell. Prop. Rev. 460 (1993) 15

Supreme Court Rule 15.2 28

ARGUMENT

I. A PATENTEE CANNOT ALTER THE SCOPE OF ITS PATENT MONOPOLY BY IMPOSING "CONDITIONS" ON USE OR RESALE FOLLOWING AN AUTHORIZED SALE

1. LGE all but abandons the reasoning on which it prevailed below. Several of its *amici* do try to defend the Federal Circuit's "conditional sales" jurisprudence, but only by disregarding the actual reasoning of this Court's exhaustion cases to mischaracterize them as antitrust decisions. PetBr-30–33; USBr-22–23.

Rembrandt argues, for example, that *United States v. Univis Lens Co.*, 316 U.S. 241, 249–52 (1942), "employs broad language in holding that a restriction on resale prices charged by licensees was not made enforceable under the patent law if unlawful under the antitrust laws." RembrandtBr-16. That is precisely backwards: *Univis* first examined whether the patent had been exhausted in order to determine whether the restriction was "excluded by the patent monopoly" from antitrust scrutiny. *Univis*, 316 U.S. at 243, 251.

Amici's argument that the exhaustion precedents have been undermined similarly presumes, incorrectly, that those cases rested on antitrust or misuse principles. Cases like *Leegin Creative Leather Products, Inc. v. PSKS, Inc.*, 127 S. Ct. 2705 (2007), and *Illinois Tool Works, Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006), address only how vertical restraints should be analyzed under the antitrust laws—not the scope of the patent monopoly. (Although the respondent in *Independent Ink* had previously been sued for infringement, any exhaustion issues plainly were not before this Court.)

2. LGE and *amici* strain to bring this case within the rule permitting limited-scope manufacturing licenses. But Quanta is a *purchaser*, not a manufacturing licensee within the meaning of the cited cases.

First, LGE argues that exhaustion is inapplicable because this case involves restrictions on the right to "make" the patented combination, not restrictions on the right to "use" or "sell" components purchased through authorized sales. That just ignores the central issue. The articles LGE authorized Intel to sell have no reasonable use other than to be finished into the completed invention. Here, as in *Univis*, there is no coherent distinction between *using* the purchased components and *making* the completed invention—and so the question for decision is whether the purchaser can be recharacterized as a manufacturing licensee to trump exhaustion. *Univis* holds that it cannot. If the sold article embodies essential features of the invention and is inevitably destined to be finished into it, exhaustion attaches. Put differently, LGE just assumes that the invention is not sufficiently "made" to trigger exhaustion until the article is finished and directly infringing. This Court held otherwise half a century ago in *Univis*.[1]

For similar reasons the special issues raised by self-replicating seeds and software are irrelevant here. Restrictions can always be placed on the use or sale of a new second generation of the sold good. But Quanta

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[1] Some of LGE's *amici* argue that a patentee could authorize a licensee to "sell" the article without conveying to anyone the right to "use" it. Obviously that is inconsistent with traditional exhaustion principles, and LGE does not endorse it.

does not create a new second generation of microprocessors; it just wants to use the physical articles it purchased for their only reasonable use.

In a footnote LGE weakly attacks the district court's finding, undisturbed by the Federal Circuit, that these microprocessors and chipsets have no reasonable use other than to practice the patents in suit. It is *always* true that a product could have its patented features removed or disabled, be used beyond the reach of U.S. patent law or as a replacement part for an authorized repair, or be resold to a hypothetical purchaser that already has a separate license to use from the patentee. Pet.App.46a-49a. If those possibilities count as non-infringing uses for purposes of exhaustion or contributory infringement, both doctrines would be nullified. *See Lucas Aerospace, Ltd. v. Unison Indus., L.P.*, 899 F. Supp. 1268, 1287 (D. Del. 1995) ("[T]he phrase 'substantial noninfringing use' relates not to whether the portion of the invention supplied by the contributory infringer may be used or sold *outside* the United States, but rather toward whether that component has a use other than to be combined with other items that together fall within the metes and bounds of the claims of the patent."). And even a legitimate non-infringing use does not count if it is "farfetched, illusory, impractical or merely experimental." *E.g.*, Donald S. Chisum, *Chisum on Patents* §17.03 (2007); *see also In re Aimster Copyright Litig.*, 334 F.3d 643, 653 (7th Cir. 2003), *cert. denied*, 540 U.S. 1107 (2004); *Dennison Mfg. Co. v. Ben Clements & Sons, Inc.*, 467 F. Supp. 391, 428 (S.D.N.Y. 1979).[2]

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[2] LGE also suggests (RespBr-53 n.19) that it might still argue

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Second, LGE tries to convey the impression that Intel was licensed to sell its microprocessors and chipsets only under what LGE calls the "component" patents, but not under the "systems and method patents" at issue here. *E.g.*, RespBr-6. That is obviously incorrect and inconsistent with LGE's arguments and the findings of both courts below. Paragraph 3.1 of the Intel-LGE License Agreement (JA154) gives Intel a worldwide license to "make, use, [and] sell" "Intel Licensed Products" (*see* JA149(¶1.13); Pet.App.45a-46a; LGE Fed. Cir. Br. 11) [redacted] The courts below correctly recognized that "LGE granted Intel a license covering its entire portfolio of patents" and that Intel sold these microprocessors and chipsets to petitioners "with LGE's authorization." Pet.App.5a; *see also id.* at 29a ("The LGE-Intel License gives Intel the right to manufacture products that would otherwise infringe any of the patents owned by LGE, including the patents at issue here."). Indeed, LGE concedes in its brief to this Court that "LGE's licensing arrangement with Intel eliminated Intel's potential

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that exhaustion should not apply because these sales may have occurred outside the United States. LGE has never made this argument before, never even requested discovery on the locus of Intel's sales to Quanta, and has clearly waived this issue. Regardless, *Boesch v. Graff*, 133 U.S. 697 (1890), involved sales overseas authorized only by the holder of a *foreign* patent. LGE owns the U.S. patent and gave Intel a *worldwide* license. LGE is invoking the jurisdiction of U.S. patent laws because the products were destined for sale here. The distinction LGE suggests would just arbitrarily encourage patentees to prefer assembly chains outside the United States to those within, for products destined for the United States. No remand is necessary.

liability for *contributing to* infringement of those [system and method] patents by its customers." RespBr-10 n.7. In other words, Intel had authority under the system and method patents to make these sales that, in the absence of such authority, would have contributorily infringed. [redacted]

Third, LGE argues that this case is like *General Talking Pictures Corp. v. Western Electric Co.*, 305 U.S. 124 (1938), because Intel supposedly lacked authority to convey the right to combine the sold components with non-Intel parts. RespBr-39–42. But the holding of cases like *General Talking Pictures* is that a sale knowingly in violation of a manufacturing license makes both the licensee and purchaser infringers. Again, LGE concedes that Intel had full authority to sell to Quanta. Simply redescribing an attempted restriction on downstream purchasers as a restriction on the rights the licensee could convey to the purchasers does not change its nature or negate exhaustion. Under either formulation, an authorized sale (even one with attempted "conditions" or reservations) necessarily exhausts the patentee's statutory rights.

Hence in cases like *Adams v. Burke*, 84 U.S. (17 Wall.) 453 (1873), *Hobbie v. Jennison*, 149 U.S. 355 (1893), and *Keeler v. Standard Folding Bed Co.*, 157 U.S. 659 (1895), this Court held that field-of-use limitations on manufacturing licensees could not be enforced against legitimate purchasers. LGE argues

that those patentees just didn't say the right words, but of course this Court applied exhaustion despite the patentees' vigorous contentions that the restrictions *were* meant to bind purchasers.

Fourth, LGE and certain *amici* profoundly misunderstand the traditional doctrinal distinctions by wrongly suggesting that petitioners propose an arbitrary distinction between patentee sales and licensee sales. Petitioners fully addressed that misconception in their certiorari reply (at 2–4). A patentee can limit who it chooses to sell to, and can restrict who its licensees are authorized to sell to. But neither the patentee nor a licensee can sell an article with authority *without exhausting the patent monopoly in that article.*

3. Even if parties were allowed to "opt out" of exhaustion, LGE and Intel did not. The License says that "[n]otwithstanding anything to the contrary contained in this Agreement, the parties agree that nothing herein shall in any way limit or alter the effect of patent exhaustion that would otherwise apply when a party hereto sells any of its Licensed Products." JA164(¶3.8). LGE itself relies on a strong reading of that proviso to acknowledge that its rights in the "component" patent were exhausted, despite explicit language in the License that "nothing in the licenses granted hereunder or otherwise contained in this Agreement shall ... give either party any right to license the other party's Patents to others." *See* RespBr-5 n.4, 8 n.6. That clause (¶3.8(a)) immediately precedes and is precisely parallel to the more specific one (¶3.8(b)) about downstream combinations with non-Intel components on which LGE hangs its entire argument.

Intel and LGE obviously had a legal disagreement about whether exhaustion would prevent enforcement of LGE's downstream "conditions," and resolved it by agreeing to be bound by the exhaustion doctrine—however that doctrine might be interpreted. Having agreed to that provision LGE is perhaps free to argue (as it did below) that the traditional doctrine permits "conditions" on end users. But it cannot genuinely claim that it negotiated a waiver of that doctrine.

II. AUTHORIZED SALE OF AN UNFINISHED ARTICLE OR COMPONENT CAN TRIGGER EXHAUSTION UNDER THE *UNIVIS* TEST

LGE's principal argument is now that exhaustion is only triggered by sale of a fully infringing article. That is precisely the argument made by the patentee, and rejected by this Court, in *Univis*. This Court held instead that exhaustion is triggered by the sale of any "uncompleted article which, because it embodies essential features of his patented invention, is within the protection of his patent [and is] destined ... to be finished by the purchaser in conformity to the patent." 316 U.S. at 251.

LGE's efforts to distinguish *Univis* are unpersuasive.

1. LGE argues that *Univis* was in part an implied license decision. RespBr-28–29. But the only "license" this Court could have been referring to is one implied in law, because its decision nullified explicit contractual restrictions contained in the parties' license agreements. PetBr-25–28. LGE never grapples with this reality.

LGE finally now concedes that "the two doctrines

rest on wholly distinct foundations." RespBr-23; *see also id.* at 11. But the traditional exhaustion doctrine applied in *Univis*, properly understood, does not "nullif[y] the very concept of implied license." RespBr-23. Sale of a component exhausts a system or method patent only in the very limited circumstances identified above and present here. Implied license occupies a substantially broader field, as LGE itself acknowledges. *Id.* (implied license covers any uses the parties "could reasonably anticipate").

2. LGE argues that in *Univis* the lens blanks were purportedly manufactured and ground "under the *same patent*," RespBr-26, and this Court "'put to one side questions which might arise if the finisher of a particular lens blank utilized the invention of some patent other than the patent which was practiced in part by the manufacturer of the blank.'" RespBr-28 (quoting 316 U.S. at 248). LGE argues that here there are "independent patents for the components and for the systems" which must mean the PTO determined that the combination assembled by Quanta is "patentably distinct" from the components sold by Intel. RespBr-13, 18. LGE's attempted "two patent" distinction fails for several reasons.

First, it fundamentally misunderstands patent law and oversimplifies the facts in this case. *Products* are not patented, *inventions* are. It is not important to patentability whether a claim describes a "component" or instead a broader "system" in which it operates, so long as the claim includes novel features. And the fact that a *different* patent may be infringed by some subset of the system does not mean that the remainder is necessarily "patentably distinct." The inventor of a gas-electric hybrid drive could legitimately seek a

patent claiming only the novel drivetrain, or a patent claiming a complete car incorporating that drivetrain. (The latter would actually be a *narrower* patent claim, since it would add more limitations.) *See, e.g., Pierce v. Allen B. Dumont Labs., Inc.*, 297 F.2d 323, 326 (3d Cir. 1961) (noting that patent "claimed a radio transmitting and receiving system wherein the new stabilizing Pierce oscillator was joined in effective combination with other elements of such a system which, admittedly, were old and familiar in the art"), *cert. denied*, 371 U.S. 814 (1962). If the latter, then an "everything but tires" assembly might not directly infringe, although it would certainly contributorily infringe and satisfy the *Univis* test for exhaustion. LGE wrongly assumes that if any other patent fully reads on the "everything but tires" assembly (perhaps a patent on a smudge-proof dashboard coating) then the PTO has necessarily determined that a car with tires is "patentably distinct" from one without—and that sale of a car without tires should not exhaust the patent.

The facts here illustrate the point. LGE claims to have patents covering the microprocessors and chipsets independently. But as *amici* explain there are tens of thousands of separately patented inventions embodied within Intel's microprocessors and chipsets. The only patent LGE points to, U.S. Patent No. 5,123,108, has absolutely nothing to do with the memory coherence and bus arbitration functions at issue here. It teaches how to bypass register files to speed CPU processing. It is, in other words, a patent on a smudge-proof dashboard coating.

It is not inconsistent with any determination by the PTO to recognize the obvious truth (which LGE *still*

does not attempt to deny or rebut factually) that everything novel or inventive about the patents in suit is contained or executed wholly within the microprocessors and chipsets. PetBr-6–7.[3]

Second, any dispute about that is irrelevant in any event. Quanta has never suggested that the Intel components "embody *every* feature of LGE's patented systems." RespBr-17 (emphasis added). And that is not what *Univis* requires. This Court drew the line in *Univis* at contributory infringement rather than direct infringement. And that makes perfect sense, given that (as illustrated above) the difference between contributory and direct infringement is often an arbitrary matter of claims drafting. LGE cannot and does not actually dispute that Intel's microprocessors and chipsets embody essential features of the patents in suit. Indeed, it admits that Intel contributorily infringed when it sold microprocessors and chipsets to Quanta pre-License. RespBr-31, 10 n.7.[4]

For the same reason, *Aro Manufacturing Co. v. Convertible Top Replacement Co.*, 365 U.S. 336 (1961), *Mercoid Corp. v. Mid-Continent Investment* Co., 320 U.S. 661 (1944) ("*Mercoid I*"), and the other cases LGE relies on are inapt. RespBr-18, 22. Of course the

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[3] LGE invokes the "two-court rule" to support the irrelevant point that the microprocessors and chipsets alone would not be directly infringing. RespBr-27. Neither court below considered at all whether the combination was "patentably distinct" from those features found solely on the microprocessors and chipsets.

[4] LGE's charge that Quanta is receiving a "windfall" by "paying for an inexpensive item and then selling vastly more expensive products" is absurd. RespBr-34–35. The price of a laptop computer includes the cost of many other components (and inventions) that have nothing to do with LGE's patents.

microprocessors and chipsets are not "'*identical* with the combination,'" but that would only be relevant if the test was direct infringement. RespBr-18 (citation omitted) (emphasis added). And, as Congress confirmed with its 1952 amendments, adding §271(c) and codifying the law as it existed pre-*Mercoid*, any unauthorized "offer[] to sell" a "component" of a "combination" which "constitut[es] a material part of the invention" with no "substantial noninfringing use" *is* contributory infringement. That is the line this Court chose in *Univis*, and that is why Intel needed and obtained a license to sell the components under LGE's combination patents.

Third, LGE misunderstands the question "put to one side" in *Univis*. Quanta did not "utilize[] the invention of some patent *other than* the patent which was practiced in part by [Intel]." 316 U.S. at 248 (emphasis added). Intel "practiced in part" the combination patents in exactly the same sense that the lens blank manufacturer practiced in part the patents that read onto the finished lenses in *Univis*. And the lens blanks sold in *Univis* were also covered by separate patents fully practiced by the manufacturer of the blank. *Id.* at 246 (of the thirteen patents at issue, five were fully practiced in making the lens blanks)

3. LGE then attempts to distinguish *Univis* on the cryptic ground that "[t]he modifications made by the retailers ... did not alter the basic nature of the manufactured articles and were not capable of being awarded independent patent rights," whereas supposedly here "[t]he components sold by Intel do not constitute the entire physical structure of the patented systems." RespBr-26, 27. *Univis* provides no basis for an arbitrary distinction between components that are

"modified" post-sale and those that are combined with other generic components. Nor does LGE explain why, for example, a claim calling for the downstream purchaser to cut a hole out of a solid circle should exhaust a patent owner's rights, but a claim requiring that purchaser to fill a hole in a hollow circle should not.

Any such rule would be vague and unworkable. The contributory infringement line this Court drew in *Univis* has survived for over sixty years and incorporates a well-understood body of law. Applying that standard here does not mean that "the first lawful conveyance of *any* component exhausts the patent holders' rights in the patented system." RespBr-25 (emphasis added). Nor does it extinguish "the patent holder's rights in *any* independently patented system in which the article will be used." *Id.* at 23 (emphasis added). Only if the patentee authorizes sale of a component that embodies essential features of the invention *and* has no other reasonable use but to be finished into a fully infringing article is exhaustion triggered.

III. SECTION 271(D)(2) DID NOT OVERRULE *UNIVIS*

LGE and its *amici* argue that 35 U.S.C. §271(d)(2) should be read literally to abolish exhaustion for authorized sales by contributory infringers. That argument was not made below, nor in the brief in opposition, and is waived. And in the 55 years since Congress enacted §271(d)(2), we have not identified a single court or commentator that has ever suggested this interpretation (nor, apparently, have LGE or its *amici*). Indeed, to our knowledge this issue appeared

for the first time in a footnote in the United States's brief supporting certiorari (at 20 n.7), which identified the argument but concluded that the statute could not plausibly be read that way.

Congress adopted §271(c) and (d) "for the express purpose of reinstating the doctrine of contributory infringement as it had been developed by decisions prior to" the *Mercoid* decisions. *Aro Mfg. Co. v. Convertible Top Replacement Co.*, 377 U.S. 476, 492 (1964) ("*Aro II*"). In the *Mercoid* decisions this Court expansively construed the misuse doctrine to prohibit *all* attempts to control unpatented components or materials, essentially swallowing contributory infringement law. *See Mercoid I*, 320 U.S. at 664–65. Paragraph (c) "adopts a restrictive definition of contributory infringement," which is "counterbalanced by limitations on patent misuse in § 271(d)." *Dawson Chem. Co. v. Rohm & Haas Co.*, 448 U.S. 176, 200–01 (1980). Subsection (d) lists five things a patentee may do, and "uses language broad enough to push back both the misuse doctrine and any conflicting judicial interpretation of antitrust law, as such, in the phrase 'misuse or *illegal* extension of the patent right.'" Giles S. Rich, *Infringement Under Section 271 of the Patent Act of 1952*, 35 J. Pat. Off. Soc'y 476, 499 (1953) (quoting §271(d)).

LGE and its *amici* rip §271(d)(2) out of the overall structure and purpose of the statute, and fail to account for the fact that it applies only to patent owners "*otherwise entitled to relief.*" LGE is not "otherwise entitled to relief," because exhaustion independently bars recovery. And the phrase "shall [not] be denied relief" just means, in context, that a misuse defense will not apply in an infringement or contributory

infringement action simply because the patent owner engaged in one of the listed activities. *See, e.g.*, *Dawson*, 448 U.S. at 187–214 (describing decisional and legislative history); *Aro II*, 377 U.S. at 492. In other words, "[n]o patent owner otherwise entitled to relief ... shall be denied relief [*for*] or deemed guilty of misuse or illegal extension of the patent right" solely by doing any of those things. The word "for" is implicit, or at most its omission is a classic "scrivener's error," and it is entirely "within [the] Court's competence" to correct such errors. *Dir., Office of Workers' Comp. Programs v. Newport News Shipbuilding & Dry Dock Co.*, 514 U.S. 122, 142 (1995) (Ginsburg, J., concurring); *see also, e.g.*, *United States v. X-Citement Video, Inc.*, 513 U.S. 64, 82 (1994) (Scalia, J., dissenting). LGE's expansive reading of "shall [not] be denied relief" produces the absurd result that a patentee could sue for contributory infringement even where it has licensed the supposed contributory infringer. "Where the literal reading of a statutory term would 'compel an odd result,'" the Court "must search for other evidence of congressional intent to lend the term its proper scope." *Pub. Citizen v. U.S. Dep't of Justice*, 491 U.S. 440, 454 (1989) (citation omitted).

Nothing in the legislative history of §271(d) even remotely suggests that Congress *sub silentio* overruled *Univis*, and no court has ever read the statute that way. As this Court cautioned in *Deepsouth Packing Co. v. Laitram Corp.*, 406 U.S. 518, 531 (1972), "we should not expand patent rights by overruling or modifying our prior cases construing the patent statutes, unless the argument for expansion of privilege is based on more than mere inference from

ambiguous statutory language."

IV. ANY MODIFICATION OF TRADITIONAL EXHAUSTION PRINCIPLES MUST COME FROM CONGRESS

The exhaustion doctrine has been "a fixture of US patent law" "[f]or over a century." Richard H. Stern, *The Unobserved Demise of the Exhaustion Doctrine in US Patent Law*, 15 Eur. Intell. Prop. Rev. 460, 460 (1993). It represents an application of ordinary personal property principles to patented articles that is perfectly sensible and consistent with the statutory scheme. *See* 35 U.S.C. §261 ("Subject to the provisions of this title, patents shall have the attributes of personal property."); Stern, *supra*, at 460 ("Under the exhaustion doctrine, when a patent owner sells a patented article to a customer, ... [p]roperty law, rather than patent law, then governs customers' use of such property."); *Keeler*, 157 U.S. at 666 (purchaser "becomes possessed of an absolute property in such articles"); *Chaffee v. Boston Belting Co.*, 63 U.S. (22 How.) 217, 223 (1859) ("private individual property of the purchaser"); *Ethicon, Inc. v. U.S. Surgical Corp.*, 135 F.3d 1456, 1470 (Fed. Cir.) ("The law of patent ownership has its roots in the common law of property ...."), *cert. denied*, 525 U.S. 923 (1998). The scope of rights granted under the patent laws "must be strictly construed so as not to derogate from the general law beyond the necessary requirements of the patent statute." *United States v. Masonite Corp.*, 316 U.S. 265, 278–80 (1942).

Congress has never modified the exhaustion doctrine, despite many opportunities. LGE wrongly conflates the well-established rule that statutes should

be read in light of longstanding prior judicial interpretations with the more controversial use of legislative history. RespBr-46. And it does not deny that "Congress repealed prior patent laws and extensively revised them" in 1952, *In re Zurko*, 142 F.3d 1447, 1455 (Fed. Cir. 1998), *rev'd on other grounds*, 527 U.S. 150 (1999), which distinguishes LGE's cited language from *Alexander v. Sandoval*, 532 U.S. 275, 292 (2001), involving "isolated amendments."

Congress's decision to codify the first sale doctrine in the Copyright Act but not the patent laws does not reflect implicit disapproval of exhaustion in the patent context, but rather Congress's desire to restrict the doctrine in the copyright context. For example, Congress specified that purchase of a phonorecord or software would not convey the right to rent or lend it out "unless authorized by the owners of copyright"—presumably to facilitate certain forms of price discrimination that might otherwise be defeated by exhaustion principles. *See* 17 U.S.C. §109(b).

As noted *supra*, at 1, this Court's recent move away from *per se* condemnation of vertical restraints in the antitrust context is irrelevant. This Court has never regarded the patent laws as a broad charter for evolving common law decisionmaking like the antitrust laws. *See State Oil Co. v. Khan*, 522 U.S. 3, 20 (1997). In any event, the recent antitrust cases are about what sorts of vertical agreements may be enforced *by contract*, and do not undermine the traditional rule (from which exhaustion springs) that servitudes running with chattels are unenforceable under *property* law.

V. PUBLIC POLICY FAVORS THE TRADITIONAL EXHAUSTION DOCTRINE

The traditional exhaustion rule in no way disturbs, or even implicates, a patent owner's freedom of contract. It simply defines the limits of the *statutory* cause of action for infringement, and clarifies that patentees may not use patent law to create servitudes that run with chattels after an authorized sale and are enforceable against parties that have not agreed to them. LGE and its *amici* accept the longstanding rule against personal property servitudes in ordinary property law (RespBr-49; ProfessorsBr-14), yet cannot explain why a different rule should apply to the sale of patented articles. And they fail to recognize the consequences the Federal Circuit's holding will have for antitrust law.

1. LGE argues that the *Univis* rule produces "absurd and conflicting results" if a patent reading on a component and a separate patent reading on a system that is the component's only reasonable use are held by different people, because "the holder of the system patent could see its patent rights extinguished without its consent and without any action on its part." RespBr-24. That simply misunderstands *Univis* and the traditional doctrine. A sale authorized by one patentee does not exhaust patents *held by a different patentee*, whether those patents read on a downstream combination or even on the sold article itself.

2. LGE and its *amici* argue that "two-tiered" and other elaborate licensing arrangements would be threatened by consistent application of the traditional exhaustion doctrine, and that such arrangements are necessary to ensure that patent owners receive an

adequate reward. But their arguments will not bear close scrutiny.

First, the dire warnings of LGE's *amici* are clearly overblown. *Amici* themselves illustrate that multi-tier licensing arrangements are not difficult to achieve under traditional law, even when exhaustion would be triggered under the *Univis* test. Qualcomm explains that its manufacturing licensees are only authorized to sell to purchasers who have a separate purchasing license. QualcommBr-8–9. And, exactly like the patentee in *Mitchell v. Hawley*, 83 U.S. (16 Wall.) 544 (1873), iBiquity has licensed chip manufacturers only to make chips and loan them out pursuant to a sublicense to use—but never to "sell" them. iBiquityBr-2, 12. All of the multi-tier royalty, "patent pool," and cross-licensing arrangements that *amici* contend are essential in particular fields could easily be structured in either of these ways—with the salutary consequence that the affected downstream parties will be aware of the patentee's specific demands up front.

The Qualcomm strategy will sometimes limit the patentee to suits for breach, not infringement. But that option is good enough to keep the wheels of commerce turning in every other context. Shifting rights from contract to patent law is hardly "benign." RembrandtBr-25. Infringement suits allow patent holders to seek injunctive relief, treble damages, and attorneys fees, and extend to parties not in privity and without notice. AAIBr-15.

Second, LGE and its *amici* never coherently explain why patentees instead need the right to simply authorize non-exhaustive sales. They argue that it would be too expensive, impractical, or somehow

"inhibit efficient dissemination of the technology in the marketplace" to require purchaser licenses like Qualcomm's *before* they authorized the sale. TPLBr-19; *see also* RespBr-33–34; PapstBr-15. According to TPL, it is "far more efficient" to allow LGE to wait until purchasers "have adopted the technology, and determined its worth to them" before negotiating a license, because that way the patent owner can safely "know[] where there is market demand for the technology." TPLBr-19–20.

That argument is dangerous nonsense, and opens the door to obvious opportunities for abuse. No rational purchaser would prefer to negotiate for patent rights *after* it has already purchased the product and exposed itself to infringement liability, and there certainly is no reason to think that the negotiations will be more efficient if delayed. As *amicus* Dell Inc. observes, such delay only fosters "lock-in" effects that allow the patentee to capture the purchaser's sunk costs rather than whatever the actual *ex ante* value of the patent would have been. DellBr-12–18. And *amici* Automobile Engine Rebuilders Association describes (at 16–18) how, after *Mallinckrodt*, post-sale restrictions are a tool for "openly target[ing] lawful competition, not compensation for patent rights."

The legal regime that *amici* advocate is plainly not designed to produce the economically efficient outcome, but instead to foster information asymmetries and mistakes. Their theory is designed to help patentees lurk in the background while potentially infringing products are disseminated widely, in order to multiply the potential targets for infringement suits or shake-down licensing demands. This is the "inconvenience and annoyance to the public" that this Court

anticipated and condemned more than 100 years ago. *Keeler*, 157 U.S. at 667. Indeed, a claimed right to send products out into the stream of commerce still subject to unspecified and potentially limitless royalty demands by the patentee is precisely the form of post-sale restraint that this Court called a "perfect instrument of favoritism and oppression" in *Motion Picture Patents Co. v. Universal Film Manufacturing Co.*, 243 U.S. 502, 515 (1917).

If for some reason a patentee believes that it is necessary or efficient to divide its royalty between the first purchaser and downstream purchasers, then the only sensible and efficient rule would put the burden on the patentee to make that arrangement clear to all parties, and to negotiate its economic terms, *before* authorizing a sale that would otherwise trigger exhaustion—as Qualcomm has done. That need not even require elaborate negotiations; the patentee could simply give the manufacturing licensee a standard form license agreement for downstream purchasers (like Qualcomm's SULA licenses), and require that it be executed simultaneous with any sale.[5]

Third, LGE and its *amici* have a distorted and schizophrenic view of what constitutes "full value" for the patent. RespBr-33. The "sell first, license later" schemes they promote are designed to delay and skew licensing negotiations so that they focus not on the

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[5] As iBiquity demonstrates, nothing about the traditional rule prohibits the patentee from negotiating flexible licenses that allow companies "to share the risks of producing a product that has not yet achieved widespread market acceptance." iBiquityBr-19. For instance, the amount of royalty payments could be based on the level of acceptance of the product, or could be keyed to downstream sales or product returns.

value of the patent, but instead on the purchaser's sunk costs. Successive negotiations with different stages of the distribution chain also allow the patentee to extract nuisance royalties from each target, because no company separately has sufficient incentive to litigate.[6]

LGE's *amici* acknowledge the economic truism that there is only one "monopoly" profit in any vertical distribution chain, but nevertheless argue that it is somehow necessary for a patentee to set up multiple toll booths in that same chain in order to secure its fair reward. They suggest that component manufacturers would be unwilling or unable to pay upfront the "full [downstream] value, measured as a reasonable royalty," because the cost would greatly inflate the component price, and downstream purchasers would be unwilling to pay it. *See, e.g.*, AmberwaveBr-19–20. That makes no economic sense. If a downstream assembler would be willing to pay X for a component and then Y to the patent owner for the right to use it, it would logically be willing to pay the component manufacturer X+Y for the same bundle of rights—unless it is somehow essential to the patentee's strategy to confuse the downstream buyer or (as Amberwave's discussion suggests) part of Y reflects the nuisance value of resolving threatened patent litigation.[7]

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[6] *Amici* Wi-LAN may be correct that the traditional doctrine "propel[s] electronic component manufacturers ... into conflict with patent owners" (Wi-LanBr-2), but public policy favors encouraging challenges to dubious patent demands. *See Lear, Inc. v. Adkins*, 395 U.S. 653, 670–71 (1969).

[7] It also makes no sense to suggest, as some *amici* do, that component makers cannot pass along high royalty rates because they face "fierce competition" for OEM sales. InterDigitalBr-12–

LGE and its *amici* suggest that if exhaustion were triggered by sale of a component, then patentees would be unable to realize the separate value of a patent that is directly infringed only at a later point. *See, e.g.*, InterDigitalBr-11–12. But the value of any patent is just how much royalty burden the production chain can bear before either (a) the price of the end product is raised, and sales depressed, beyond the profit-maximizing equilibrium for the patentee, or (b) the chain has sufficient economic incentive to design around or substitute away from the patent. The former is the same whether the patentee has one patent or twenty.[8] Additional patents may increase (b), but again the downstream infringer's calculus is the same whether it is paying (X+Y) to the component seller or X to the component seller and Y to the patentee.

Fourth, LGE and its *amici* argue that the first purchaser will often lack sufficient information about the value of the patent to downstream buyers. But the first purchaser can negotiate with its own customers as easily as the patentee can. Upstream suppliers must negotiate for crucial inputs to distribution chains all the time, and business does not grind to a halt. (An oil

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13. If competition for OEM sales makes component manufacturers unwilling to pay for patent rights, it could only be because those patent rights are not necessary or not valuable—*e.g.*, if it is more cost-effective for the component manufacturer to design around the patent than to pay the demanded royalty.

[8] *See* Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 407–10 (4th ed. 2005). A different result would obtain if patents were held by separate patentees, but only because independent profit-maximizing behavior by the second patentee leads to less output, higher prices, and lower total profits than in the single-patentee scenario. *Id.* at 415–18.

company negotiating a drilling lease must keep its eye on the price that downstream refiners are obtaining for gasoline.) And the patentee would have every incentive to share its own information with the first purchaser.

The real information problem is created by the proposals of LGE and its *amici*. Amberwave suggests that a downstream purchaser would never pay the "full value" of the patent to a component manufacturer because "it would be depriving itself of the ability to make a purchasing decision based on the value that it receives from practicing the patents applicable to the component." AmberwaveBr-5. To the contrary, internalizing the "full value" of patents necessarily infringed by the only reasonable use of a component *into the price of that component* is the best way to allow downstream buyers to make an apples-to-apples comparison. Otherwise the downstream purchaser cannot know what that component will cost it until the patentee makes its royalty demand. The traditional exhaustion rule thus solves far more negotiation problems than it creates.[9]

Fifth, as predicted (PetBr-50), the only coherent policy justification offered by LGE and its *amici* is that a strong exhaustion rule sometimes permits arbitrage

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[9] Amberwave also argues that if the full royalty is internalized into the component price downstream buyers will lose all ability or incentive to challenge the patentee's infringement claims. AmberwaveBr-5. Of course any incentive the downstream buyer lost, the upstream seller would gain. Regardless the premise is incorrect. *Both* parties would have an incentive to challenge the patent, and after *MedImmune, Inc. v. Genentech, Inc.*, 127 S. Ct. 764 (2007), the downstream buyer could bring a declaratory judgment action on the basis of the inflated prices it is paying.

to erode price discrimination strategies. Their analysis is, however, simplistic and incomplete. Ordinary sellers do not have the right to prevent all arbitrage, beyond what can be enforced by contract. And unexpected uses of sold products have always been a source of significant innovation and economic activity. If someone figures out how to use a truck to power a mill and grind flour, the truck seller has not been swindled merely because he was deprived of an opportunity to charge that buyer a ten-fold higher price. LGE's suggestion that patentees will withhold inventions from the marketplace unless they can arrange to capture all such unexpected benefits is simply absurd.

And while price discrimination between different groups of buyers generally makes the seller better off at the expense of buyers, the effects on net societal welfare (allocative efficiency) are ambiguous—"better or worse than nondiscriminating monopoly pricing from an efficiency viewpoint, depending on the shapes of the demand and cost curves." Carlton & Perloff, *supra*, at 306. Economic analysis suggests no reason for this Court to give patent owners more powerful price discrimination tools than are enjoyed by ordinary sellers, in the absence of some direction from Congress. In most circumstances the increased reward to the patentee would not even be related to the inventive value of the patent. (A patent on smudge-proof dashboard coatings might, for example, just give Ford an excuse to discriminate between customers who use their pickup truck to haul scrap wood and those who haul scrap aluminum.)

Sixth, LGE and its *amici* are deeply incoherent on the question of whether any notice would be required

to downstream purchasers.

For example, Yahoo! argues (at 13) that effective notice would cure any external information costs. But it does not explain where such a notice requirement would come from, doctrinally, or how the adequacy of a particular notice would be judged. LGE's position, shared by many *amici*, is that "'[n]o one can convey ... any better title than he owns.'" RespBr-39 (citation omitted) (omission in original); MPEGLABr-15 n.9; AerotelBr-11. Under that rationale, notice is irrelevant. *Amicus* Intellectual Property Owners tries to split the difference by saying that notice is necessary, "but only by the patentee to the first purchaser or first licensee." IPOBr-14.

Without a notice requirement, any "optional" exhaustion doctrine would be tremendously unfair and inefficient. But LGE's *amici* implicitly concede that this Court would have to construct a new jurisprudence of effective notice from whole cloth. The Federal Circuit has pretended to locate such a jurisprudence in the Uniform Commercial Code, but its analysis is so obviously incorrect that neither LGE nor any of its *amici* attempt to defend it.

3. Neither LGE nor any of its *amici* engage at all with the obvious threat to antitrust law posed by permitting post-sale restraints to be enforced under the umbrella of the patent monopoly. PetBr-50–51; USBr-29. They assert that "[t]ying arrangements and price controls, as well as other anticompetitive restrictions on the 'use' and sale of patented articles, would continue to be outside the patent protection and fully subject to antitrust scrutiny." RespBr-48. But that simply is not an accurate statement of the law.

This Court upheld price-fixing conditions in *United States v. General Electric Co.*, 272 U.S. 476 (1926), and *Bement v. National Harrow Co.*, 186 U.S. 70 (1902), precisely because they were imposed through a licensing scheme that fell within the scope of the patent grant. PetBr-32. And the entire question for decision in *Univis* was whether vertical resale price maintenance that would otherwise have been *per se* illegal at the time was nonetheless sheltered from antitrust by the patent laws. 316 U.S. at 251–52.

The Federal Circuit has pretended to turn that analysis upside down, by ostensibly making the enforceability of conditions under patent law depend on whether those conditions violate antitrust law. But that inversion is only skin deep. The Federal Circuit does not genuinely examine whether conditions have anticompetitive effects, but just whether they are related "to subject matter within the scope of the patent claims." *Mallinckrodt, Inc. v. Medipart, Inc.*, 976 F.2d 700, 708 (Fed. Cir. 1992); *see* AAIBr-24–25. [10]

4. LGE suggests that license agreements entered *before* infringement should be treated the same as settlement agreements *after* infringement, which permit a patent owner to sue both direct and contributory infringers at the same time and settle separately. But LGE fails to reconcile its argument with the rule that patent owners are entitled to collect only one reasonable royalty from all potential

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[10] AIPLA argues that "[t]here is no *per se* anti-competitive effect in allowing licensors and licensees the freedom to create" post-sale restrictions. AIPLABr-2. But under the Federal Circuit's approach, post-sale restrictions are effectively *per se lawful*.

infringers. *See, e.g., Glenayre Elecs., Inc. v. Jackson*, 443 F.3d 851, 864 (Fed. Cir.), *cert. denied*, 127 S. Ct. 582 (2006); *Lucent Techs. Inc. v. Gateway, Inc.*, 509 F. Supp. 2d 912, 937 (S.D. Cal. 2007). Courts can assess that in a litigation context, where damages are evaluated in dollars. But neither LGE nor its *amici* suggest any way for this Court (let alone Quanta) to assess whether the royalty already paid by Intel (consisting of large monetary payments and a cross-license to Intel's unfathomably valuable patent portfolio) constituted an appropriate reward. The only sensible prospective rule is to force patent owners to decide themselves whether the consideration offered for the right to sell infringing (and contributorily infringing) products is sufficient.

5. Several *amici* suggest that patentees need the ability to declare peace with regard to products (such as general purpose microprocessors) where patent rights are hopelessly tangled and overlapping, while retaining the right to enforce those patents against downstream products. Of course moving downstream just adds even more patents and complexity to the calculus. Regardless, as Qualcomm proves it is easy to structure multi-tier licenses consistent with traditional law; you just have to negotiate with the downstream purchasers (or pick a standard royalty) in advance of the sales.

Other *amici* argue that exhaustion should not be triggered by licenses granted for no consideration at all, or by bare covenants not to sue (which they assume are different in some way from a true license). This Court could reserve such questions, since they are not remotely presented here. LGE received ample consideration from Intel in exchange for what both

courts below recognized was a full license to "make, use, [and] sell" the products at issue. JA154(¶3.1); *supra*, at 4-5. LGE has never contended otherwise, and failed to dispute petitioners' factual characterizations to that effect in the petition. *E.g.*, Pet-3; S. Ct. R. 15.2.

VI. METHOD PATENTS CAN BE EXHAUSTED

LGE's brief defense of the Federal Circuit's assertion that method claims can never be exhausted rests on the same arbitrary formalism as its central argument, refuted *supra*, at 8-10. LGE correctly points out that a sold article, standing alone, cannot *directly* infringe a method patent (just as it cannot directly infringe a patent covering a broader system to which that article is a necessary component). But under *Univis* exhaustion is triggered by sale of *contributorily infringing* articles as well, and a sold article certainly can contributorily infringe a method patent. LGE's attempt to distinguish *Univis* and *Ethyl Gasoline Corp. v. United States*, 309 U.S. 436 (1940), is baffling. *Ethyl Gasoline* clearly held that a method patent practiced only by the downstream purchaser was exhausted by an upstream sale of lead additive. PetBr-35.

As the method patent in *Ethyl Gasoline* illustrates, the distinction between apparatus and method patents is often an arbitrary matter of claims drafting. *See* PetBr-35–38; NCRBr-5–15. Even LGE's *amicus* AIPLA concedes that it makes no sense to "apply[] the law differently to ... method and product claims" where, as here, "the component is being used for one of the intended, claimed methods." AIPLABr-7.

CONCLUSION

The Federal Circuit's holding that patent exhaustion does not apply should be reversed.

Respectfully submitted,

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